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The Tax Cuts and Jobs Act of 2017 significantly altered Code Sec. 1031. Now, only exchanges of real property qualify for Code Sec. 1031 nonrecognition. To many observers, the real-property limitation might appear to be a simplifying convention, but this new feature adds a real-property requirement, which appears to be different from the like-kind requirement, to Code Sec. 1031. The real-property requirement mandates a definition of real property, and various alternatives are available for consideration. Other provisions of the 2017 Act also raise questions regarding their application to Code Sec. 1031 exchanges. Finally, other changes to the Code Sec. 1031, such as the repeal of the list of disqualified assets, may affect the application of Code Sec. 1031. This article discusses aspects of the new Code Sec. 1031 and other provisions that affect Code Sec. 1031 exchanges.

THE REAL-PROPERTY REQUIREMENT

Code Sec. 1031 is now a radically different provision than it was last year. Now, it only allows nonrecognition on exchanges of real property.1 Thus, exchanges of most art, collectibles intangibles, and other personal property no longer qualify for Code Sec. 1031 nonrecognition. Code Sec. 1031, therefore, no longer covers exchange programs, and the examples of like-kind intellectual property (a copyright of a novel for the copyright of another novel—like kind; copyright of a novel and copyright of song—not like kind) no longer have legal relevance, but they remain interesting from a historical perspective. Understanding the relevance of the new real-property requirement requires juxtaposing it against the like-kind requirement.

THE LIKE-KIND REQUIREMENT

By limiting the application of Code Sec. 1031 to real property, the 2017 Act adds a new requirement to Code Sec. 1031(a)(1). Now, to qualify for Code Sec. 1031, a transaction must: (1) be an exchange (2) of like-kind (3) real property (4) held for use in a trade or business or for investment. A description of like-kind requirement shows that it requires more than merely classifying property as real or personal: [S]ection 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, and the duration, nature, or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, section 1031(a) refers to property of a like—not an identical—kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new...
kind of asset or has merely exchanged it for an asset of like nature or character.\(^5\)

This language does not refer to property classification, but instead reinforces the idea that the like-kind standard requires examining the nature and character of property. A large body of case law and rulings addresses the like-kind requirement and helps determine whether the nature and character of two pieces of property make them like kind.\(^4\) That body of law reinforces that simply classifying two properties as real property is not sufficient to conclude they are like kind, so the notion that all real property is like kind is a misconception. As the IRS stated, “the fact that two varieties of property … may be classed as real property does not of itself signify that the two are property of like nature or character within the meaning of [Code Sec. 1031(a)].”\(^9\)

Because many properties that may come within the definition of real property (which, as discussed below, is not an established definition under Code Sec. 1031) are like kind, generally it is partial interests in real property that are not like kind to general interests in real property (i.e., land and improvements). Furthermore, because the like-kind requirement focuses on nature and character of property, some types of personal property can be like kind to general interests in real property. For instance, nonperpetual water rights may be real property under state law but not be like kind to general interests in real property; some timber rights that might be real property under local law may not be like kind to general interests in real property; leasehold interests in real property, which are intangible personal property for some federal tax purposes and can be personal property under state law,\(^8\) can be like kind to general interests in real property;\(^9\) and shares of stock in a residential cooperative corporation, the legal classification of which may be uncertain under local law, can be like kind to a condominium deed of the same property.\(^9\) Code Sec. 1031 generally does not rely upon local or state law classification to determine whether properties are like kind.\(^11\) Regardless of the scope of Code Sec. 1031’s definition of real property, apparently the like-kind standard still applies, so some assets that might come with the definition of real property may not be like kind to other property that also comes within the definition, and some property that is not real property under some definitions may be like kind to general interests in real property.

DEFINITION OF REAL PROPERTY

The manner in which the like-kind requirement applies raises questions about how it will interact with the new real-property requirement, and how the new real-property requirement affects the scope of Code Sec. 1031. The Conference Report accompanying the Code Sec. 1031 changes suggests that Congress intended rulings governing like-kind property classification to carry over to the new statute, indicating that perhaps exchanges of some types of non-real-property assets could still qualify for Code Sec. 1031 nonrecognition:

It is intended that real property eligible for like-kind exchange treatment under [old] law will continue to be eligible for like-kind exchange treatment under the [new law]. For example, a like-kind exchange of real property includes an exchange of shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) if at the time of the exchange such shares have been recognized by the highest court or statute of the State in which the company is organized as constituting or representing real property or an interest in real property. Similarly, improved real estate and unimproved real estate are generally considered to be property of a like kind. See Treas. Reg. \S 1.1031(a)–1(b).\(^12\)

Carefully parsing the three sentences in this Report may help determine if it addresses fundamental questions that the Code Sec. 1031’s new real-property requirement raises.

The first sentence refers to eligibility of real property for like-kind exchange treatment. All real property was presumably eligible for like-kind exchange treatment under the old Code Sec. 1031, even though some real property is not like to other real property. For instance, perhaps two water rights that are not like kind to general interests in real property could be like kind to each other and would have been eligible for like-kind exchange treatment. The Conference Report suggests that exchanges of such like-kind properties will continue to qualify for Code Sec. 1031 nonrecognition.

The first sentence appears to suggest that only real property will qualify for like-kind exchange treatment. If rights in exchange properties are not real property, presumably they would not be eligible for Code Sec. 1031 nonrecognition under the plain language of the new law, but when read in conjunction with the other
sentences, that result becomes less certain. The example in the second sentence of shares in the mutual ditch company suggests that the Code Sec. 1031 definition of real property may take into account state and local laws’ characterization of property as real property, which deviates from prior Code Sec. 1031 rulings. The reference in that sentence to interests in real property leaves open the possibility that the Code Sec. 1031 definition of real property may include interests in entities that are classified as real property under federal tax law. It would be shocking to find out that Congress intended to consider state-law classification in classifying property for federal tax purposes but would ignore federal tax classification of property. Surely, if legal classification matters, then federal tax classification would be important. The discussion below considers the definition of property under federal tax rules and shows that it can include interests in entities and other types of personal property.

The example in the third sentence seems benign, but its implications may be significant. Improved and unimproved real estates are generally considered property of like kind, as are a leasehold in real property of more than 30 years and other general interests in real property. Most observers would expect leaseholds in real property to continue to qualify for like-kind exchange treatment, even though federal tax law does not always treat a leasehold in real property as real property. Under that principle, perhaps other property interests that are like kind to general interests in real property will continue to qualify for like-kind exchange treatment, and thus come within the Code Sec. 1031 definition of real property. Nonetheless, neither the plain language of Code Sec. 1031 nor the Conference Report definitively resolves whether the Code Sec. 1031 definition of real property includes all property that is like kind to general interests in real property.

The resolution of unanswered questions related to the scope of Code Sec. 1031 undoubtedly depends on the Code Sec. 1031 definition of real property. In fact, Code Sec. 1031 may now require that properties first pass the real-property threshold before being tested under the like-kind requirement. The Code Sec. 1031 definition of real property will therefore be critical for several types of property interests. Because neither the new Code Sec. 1031 nor the Conference Report define real property, the focus turns to other definitions in the Code that might appropriately apply to Code Sec. 1031. The term real property is used throughout the Code, but it does not have a uniform definition. Consider four different definitions of real property that apply to different sections of the Code. This discussion considers the statutory and regulatory definitions (summarized in Table 1), but case law and rulings provide additional insight into the scope of the definitions.

**UBTI DEFINITION OF REAL PROPERTY**

The definition of unrelated business taxable income exempts rents from real property from unrelated business taxable income ("UBTI"). For purposes of that rule, real property means all real property, including any property described in Code Secs. 1245(a)(3)(C) and Code Sec. 1250(c). Both of those provisions refer to real property that is subject to the allowance for depreciation, so they do not include land, but the Code Sec. 1250 definition does include leaseholds of land as intangible real property. The reference to all real property in the UBTI definition should make the definition broad enough to include land and perhaps other assets that do not come within the definitions in Code Secs. 1245(a)(3)(C) and Code Sec. 1250(c). The Code Sec. 1250 regulations define real property as all real property other than personal property defined in Reg. §1.1245-3(b), which includes tangible personal property defined in Reg. §1.48-1(c) and intangible personal property.

**REIT DEFINITION OF REAL PROPERTY**

Rules determining the tax treatment of real estate investment trusts ("REITs") unsurprisingly include a sophisticated definition of real property. The REIT definition of real property determines types of assets and income that satisfy the REIT asset and income tests. Under the REIT definition, land and improvements to land come within the definition of real property. The definition includes supporting definitions of land, improvements to land, inherently permanent structure, building, and structural component. Local law definitions do not control the REIT definition of real property.

**CAPITALIZATION DEFINITION OF REAL PROPERTY**

The capitalization rules include the following definition of real property: land, unsevered natural products of land, buildings, and inherently permanent structures. The definition also includes a co-ownership, a leasehold, an option, or a similar interest in real property. Unsevered crops and plants are real property only if their productive period exceeds two years. Inherently permanent structures include property that is
affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Cases and rulings under the old Code Sec. 1031 provided that some interests in unsevered natural products are not like kind to general interests in real property. If the new Code Sec. 1031 were to adopt the capitalization definition of real property, some rights in unsevered natural products could be real property but might still fail to qualify as like kind to general interests in real property (perhaps such interests could be like kind to a right in other unsevered natural products). Similarly, the capitalization definition includes an option in real property. Even if an option is real property for Code Sec. 1031 purposes, it probably would not be like kind to general interests in real property. Co-ownerships and leases can be like kind to general interests in real property, so if they come within the definition of real property, they could be exchanged with most other real property under the new Code Sec. 1031.

**ECI DEFINITION OF REAL PROPERTY**

The definition of real property also factors into the determination of whether income is effectively connected to a U.S. trade or business. For the purposes of determining effectively connected income ("ECI"), real property includes (1) land and unsevered natural products of the land, (2) improvements, and (3) personal property as associated with the use of the real property. Local law definitions of real property do not control the ECI definition of real property. The distinctive feature of this definition is its inclusion of personal property associated with the use of real property. Personal property associated with the use of real property includes property such as equipment used in mining, farming, and forestry; equipment used in the improvement of real property; property used in the operation of a lodging facility; and property used in the rental of furnished office and other work space. Because this definition includes personal property associated with the use of real property, it is the broadest of the four definitions considered here. Perhaps it is the most appropriate definition for Code Sec. 1031, but, as discussed below, taxpayers may not prefer the broader definition under the current law. Table 1 summarizes the statutory and regulatory definitions of real property presented above.

With no definitive guidance regarding the Code Sec. 1031 definition of real property, none of these definitions is an obvious fit for Code Sec. 1031. The primary distinction among the definitions is that the ECI definition of real property includes personal property associated with the use of real property. Even though the other definitions do not include such personal property, the REIT rules treat some personal property as real estate assets for purposes of the asset test and treat rent from and gain from the sale of such personal property as rent from real property for purposes of its income test. These other provisions of the Code should inform the Code Sec. 1031 definition and treatment of real property. If Code Sec. 1031 must choose from among the other definitions, the question is whether the Code Sec. 1031 definition of real property should include personal property associated with the use of real property. The Code Sec. 1031 definition of real property could include personal property associated with real property without affecting the like-kind requirement. Property that comes within the definition of real property would still have to be like kind to the other exchange property to qualify for Code Sec. 1031 nonrecognition. Reading the Conference Report to rely upon legal classification of property would suggest that the Code Sec. 1031 definition of real property includes all property classified as real property under federal tax law. The following several matters illustrate the significance of the Code Sec. 1031 definition of real property and the like-kind requirement.

First, if Code Sec. 1031 adopts the ECI definition of real property, hotel furniture would come within the definition of real property. A taxpayer who transfers a hotel with all of the personal property associated with the use of the real property would, however, only defer gain on the transfer of the hotel furniture if it acquired other hotel furniture that is like kind to the transferred furniture. Thus, though the furniture may come within the Code Sec. 1031 definition of real property, it would not be like kind to general interests in real property such as land or a building, which are immovable and thus of a different nature and character than furniture. In this respect, the broader definition of real property would accommodate typical exchanges but would not affect the like-kind requirement.

Second, if the Code Sec. 1031 definition of real property does not track other sections, perhaps the state law definition will be important. Even though the REIT and ECI definitions of real property provide that state law may be important to the Code Sec. 1031 definition of real property, the problem with relying